

## Estate Planning & Elder Law

### Maybe a Discretionary Trust Isn't So Discretionary After All

By Gary R. Botwinick and  
Christopher J. Roman

In a meeting to discuss estate planning, a wealthy couple tells their attorney that they would like to make a large gift to their adult daughter, to reduce their estate and to help the daughter's family with life's financial challenges. However, the couple advises their attorney that they do not completely trust their son-in-law and they worry about the future of their daughter's marriage. The couple insists that the estate plan protect any gifts made to their daughter from their son-in-law in the event of a divorce. The attorney responds with a simple answer: a trust.

In drafting this trust for the benefit of the daughter, it is very likely that the attorney would look to vest the trustee with discretion to make distributions of the income or principal from the trust. This trust could be drafted with alternative

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*Botwinick is a partner and chairs the taxation/trusts and estates department at Einhorn, Harris, Ascher, Barbarito & Frost in Denville. Roman is an associate at the firm.*

standards of discretion to be vested in the trustee. One option is to draft the trust with a "support" standard, which directs that the trustee is granted the discretion to make distributions as the trustee deems necessary for the beneficiary's "health, education, maintenance and support" (the "HEMS standard"). Although this standard vests considerable discretion in the trustee, a beneficiary typically can compel the trustee to make a distribution by showing that it is necessary for the beneficiary's support. Likewise, a creditor (including a former spouse) of the beneficiary may be able to enforce that right as well. To protect against a beneficiary or creditor enforcing this right, the attorney may add language that prevents the beneficiary from being able to compel distributions, including typical spendthrift-clause language.

Alternatively, the attorney may choose an even broader standard; for example, a completely discretionary standard. This might include vesting the trustee with discretion to make distributions for "any or no purpose," which can be created with the following language: "The trustee shall make such payment or application for any or no

purpose, irrespective of cause or need, as the trustee shall deem to be in the best interest of such beneficiary." Under this standard, the trustee is vested with complete and uncontrolled discretion to make distributions of trust assets. Such broad discretion is more likely to prevent a creditor from compelling a distribution.

While in the past some attorneys have considered these standards as being somewhat interchangeable, a recent Appellate Division decision, *Tannen v. Tannen*, 416 N.J. Super. 248 (App. Div. 2010), should give attorneys pause where a client voices concern about the health of a beneficiary's marriage. In *Tannen*, the court contemplated adoption of §50 of the Restatement (Third) of Trusts ("§50"), which grants greater power to the beneficiaries of discretionary trusts to compel distributions depending on the standard of discretion. If the beneficiaries have greater power to compel distributions, then a creditor of a beneficiary, including an ex-spouse, will also have greater power to compel distributions.

Though the Appellate Division did not go so far as to change the law in this regard, it did indicate a belief that the Supreme Court might do exactly that, if it decides to review the decision on the losing parties' appeal. Regardless of whether the Court hears the appeal or not, *Tannen* and its implications are important to estate planners and their

clients who routinely rely on trusts to protect gifts from being considered in the divorce of a beneficiary.

Wendy Tannen appealed, among other things, a judgment of divorce entered by the Superior Court, which found that the income of a trust established by her parents for her benefit should be imputed to Wendy for the purpose of calculating the alimony obligation of her ex-husband. The trust at issue, the Wendy Tannen Trust, named Wendy as the sole beneficiary and appointed her as co-trustee along with both of her parents. The trust was a discretionary trust employing the HEMS standard of discretion and also contained language indicating that Wendy could not “compel distributions of income and/or principal” as well as a typical “spendthrift” clause.

To begin its inquiry as to Wendy’s appeal, the Appellate Division conducted a “review of the specific language” of the trust. Based on the HEMS standard of discretion, Wendy’s inability to compel distributions, and the spendthrift clause, the Appellate Division preliminarily found that the trust income was not an asset of Wendy and, thereby, not imputable to her for the purposes of the alimony calculation. Wendy’s ex-husband argued that according to §50 the trust income stream was an asset belonging to Wendy and that the court could compel a distribution from the trust because the terms of the trust must be interpreted consistently with the evolving fiduciary obligations of trustees under the *Restatement (Third) of Trusts*.

Although no reported New Jersey Appellate Division or Supreme Court case had relied upon §50, the Appellate Division acknowledged that §50 reflected a change in law in that “a beneficiary of a discretionary trust has an enforceable interest in the benefits of the trust, even if the trustees are accorded the broadest discretion.” In contrast, under current law, New Jersey courts have “repeatedly recognized the broad discretion accorded trustees of a discretionary trust, and thereby, implicitly the limits upon a beneficiary’s ability to compel a specific exercise of the trustee’s discretion.”

The change contemplated by §50 would grant beneficiaries and their creditors far greater power to compel distributions from discretionary trust than they would have under current law.

In the words of the court, applying §50 to the facts in *Tannen* “leads to some inescapable conclusions.” Specifically, the court recognized that “the benefits to which [Wendy] is entitled, and what may constitute an abuse of discretion by the trustee[s], depend on the terms of the discretion.” Moreover, where the “terms of the discretion” is the HEMS standard, the trustees’ discretion must be exercised to provide for distributions that keep Wendy in her “accustomed standard of living or station in life.”

After noting these “inescapable conclusions” and recognizing that they suggest a different outcome than under current law, the Appellate Division declined to adopt §50. Instead, the court held that the trust income was not imputable to Wendy for the purpose of alimony calculations and, in conclusion, noted that a determination to adopt the §50 “would be more appropriately made by our Supreme Court.” In other words, the court “punted.”

What should the estate planning community take from this decision? In short, there is a trend in the law toward beneficiaries of discretionary trusts having more power to compel distributions. Though New Jersey courts have not yet adopted this trend, a change may be on the horizon. To best protect a trust beneficiary from the claims of an ex-spouse in the event of a divorce, special consideration should be paid to the standard of discretion which the trust employs.

In light of *Tannen*, where a client is worried about the health of the beneficiary’s marriage, the “any or no purpose” standard is likely a better option than the HEMS standard, even if that HEMS standard is reinforced with a provision that prevents a beneficiary from compelling a distribution. The “any or no purpose” standard, or language of similar import, provides maximum discretion to the trustee and maximum

protection from creditors. Whereas in *Tannen* the beneficiary’s ex-husband presented a tenable argument that the trustees would abuse their discretion if they refused to make distributions for the “maintenance” and “support” of Wendy’s lifestyle, a trustee with an “any or no purpose” standard would, presumably, have greater discretion and authority to deny distributions for “any” reason whatsoever.

To further protect the trust, the grantor should also consider not only appointing a disinterested trustee, but prohibiting a beneficiary, who also serves as a trustee, from participating in decisions regarding discretionary distributions to herself. Although *Tannen* did not focus on the implications of Wendy serving as a co-trustee, if §50 were adopted, a disinterested trustee would have a much stronger argument for not making a distribution than would a trustee who is also a beneficiary. In other words, because the beneficiary as trustee would be seen as refusing to make a distribution to prevent the trust income from being imputed to her as income, a disinterested trustee’s determination would seem to be based solely on the circumstances relevant to the distribution, and the trustee’s obligation to the remaindermen.

Though in *Tannen* the trust income was not imputed to Wendy for the purpose of calculating alimony, if the Supreme Court does adopt §50, a disinterested trustee and the “any or no purpose” standard would provide a stronger defense for the trustees without detracting from the goals of the trust. Estate planners should be aware of the distinctions between standards of discretion and the trend in the law that *Tannen* contemplates. The losing party has petitioned the Supreme Court to review the decision, and the court will decide soon as to whether it will hear the appeal. In light of *Tannen*, where a client is concerned about the health of the marriage of a beneficiary, the drafter should consider the appointment of a disinterested trustee and the use of an “any or no purpose” standard as a better option over the HEMS standard. ■